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DEPT OF ENERGY FOR COURTNEY GILLESPIE, MARK GINSBURG, TOM CUTLER, GIULIA BISCONTI, PDAS K.FREDRIKSEN
DEPT OF TREASURY FOR STEPHANIE SEGAL
DEPT OF COMMERCE FOR ART STERN
DEPT PLEASE PASS TO EXPORT IMPORT BANK FOR JESSICA FARMER AND RAY ELLIS
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DEPT PLEASE PASS TO EEB PETER HAYMOND AND BRENDA HAENDLER

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SUBJECT: CAN ULTRA MEGA POWER PROJECTS RE-KINDLE U. S. INTEREST IN POWER GENERATION IN INDIA?

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Summary: 1. (U) The Indian Power Ministry is touting the attractiveness of ultra mega power projects (UMPPs) of 4,000 MW of station capacity at a single location. The government is taking the lead role in obtaining the necessary clearances, land, domestic fuel linkages, and an assured market for these projects to boost investor confidence and reduce risk perception. Despite this, there has been muted foreign interest in UMPPs. Our interlocutors engaged in the Indian power industry cited payment security concerns as the main factor deterring foreign participation in UMPPs. A relatively low return on equity (ROE) on the projects, and imported coal linkages, were other concerns cited as possible reasons for the low foreign interest. Nitin Johar who works for Tata Power's UMPP at Sasan dismissed many of these concerns. He pointed out that UMPPs have three layers of payment security built into all their power purchase agreements which assure prompt and regular payment. He also claimed that the ROE from UMPPs is much higher than commonly perceived. Despite Johar's claims, reported problems at Reliance Power's Sasan UMPP will hardly inspire global confidence to invest in an industry that is still haunted by the Dabhol debacle. End Summary.

Power Shortages Compel Promotion of Large-scale Projects

¶2. (U) Currently, India has an installed capacity of 140,000 MW of power. The country's per capita consumption of electricity is around one-sixth of the world average. In addition, India suffers from a 12 percent power shortage during peak hours and analysts estimate that a doubling of power generation capacity is needed within the next six years to sustain an annual GDP growth rate of 7-8 percent.

¶3. (U) To address the country's crippling power shortages, the federal Power Ministry has promoted large-scale power projects of 4,000 MW station capacity at a single location. These ultra mega power projects (UMPPs) are expected to generate cheaper power of around three to four cents per kilowatt-hour as against the current average cost of nearly seven cents per kilowatt-hour of power. At the same time, they can meet the power requirements of a number of states through the transmission of

generated power on regional and national power grids. Spread across India, they will be located either at the pithead (near a coal mine) of an assigned coal block, or along the coast to facilitate easy coal imports.

¶4. (U) The UMPPs, implemented through Public-Private-Partnerships, are to be awarded to a private domestic or foreign developer through a tariff-based competitive bidding process based on the lowest tariff quoted. The government's initial participation in these projects is aimed at enhancing investor confidence, reducing risk perception and ensuring favorable private sector participation. In the preliminary pre-bidding stage, shell companies formed to implement the UMPPs work under the government-owned Power Finance Corporation to obtain all clearances and will acquire land for the project. Around 27 clearances are needed before a power project can be commissioned. In addition, the shell companies draw up power purchase agreements with the power distribution licensees of the states that will procure power from the completed projects. This ensures that the successful bidder has an assured market to buy power at the tariff quoted.

Perception of Payment Risk Deters Foreign Investors, but UMPP Operator Says Perception is Unjustified
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¶5. (U) Power Ministry Director Sanjay Chadha, at a recent

seminar in Mumbai, claimed that since UMPPs guarantee reliable fuel supply, timely environmental clearances, and payment security, foreign investors will flock to bid for the projects. However, contrary to government expectations, there has been limited foreign interest in these projects. So far, three UMPPs of the planned 10 have been awarded and all have been secured by private domestic companies. Tata Power was awarded the Mundra project in Gujarat and Anil Ambani's Reliance Power secured the Sasan project in Madhya Pradesh and the Krishnapatnam project in Andhra Pradesh.

¶6. (SBU) Chetan Modi of Moody's who was earlier engaged in the Indian power sector believes that foreign investors, haunted by Dabhol, will never venture into the power sector in India. Most power distribution companies who buy power are still state-owned and operated, and are not financially sound, he continued. The risk of payment default for power is therefore very high, especially since the UMPPs are not backed by a sovereign guarantee, Modi maintained. Ramya Venkataraman from McKinsey pointed out that the federal government had helped state-owned electricity boards pay off their outstanding dues to government-owned National Thermal Power Corporation and Coal India in 2000-01, even though it had not provided a sovereign guarantee in these cases. Nitin Johar, the Associate Group Head - Finance of the Coastal Gujarat Power (the company implementing Tata Power's Mundra UMPP), stated that the federal government will never guarantee any project after the Dabhol controversy. Contradicting Modi's belief of a payment default risk, Johar pointed out that the power distribution companies of Gujarat, Maharashtra, Haryana, Punjab, Andhra Pradesh, Karnataka, Chhattisgarh, Delhi, and Kerala, currently pay for procured power on the first day of billing. He explained that the power industry has an in-built reward system for timely payment. State Electricity Boards (SEBs) and private power distribution companies get a 2.25 percent discount on monthly billing in case of early payment (before 30 days). This works out to an annualized discount of 26 percent which is a significant early payment incentive, he added. Power providers are assured of prompt and timely payment and so are willing to offer this monthly discount, he continued.

Three Layers of Payment Security Built into Power Purchase Agreements
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¶7. (U) Johar also explained that there are three layers of payment security built into the power purchase agreements between the UMPP provider and private or state-owned power distribution licensees (procurement companies) of the states buying power from the project. First, the power distribution companies have to provide the UMPP provider with a rolling letter of credit of 1.1 times the projected monthly billing. In case the distribution company does not pay within 30 days, then the UMPP provider can draw this letter of credit and secure payment for the first month of payment default. There is also an escrow account establishing irrevocable claim of receivables of power distribution licensees, he continued. All incremental receivables of these distribution companies over their operation

and maintenance costs, flow into this account and can be accessed in case of a default. According to Johar, this default escrow account mechanism blocks the company's cash flows and "forces" them to pay. (Comment: The escrow account mechanism enables a direct transfer of funds owed by the power procurement company to the power provider. As the defaulting power procurement company has no control over the escrow account, this mechanism prevents a Dabhol-like situation from re-occurring where the Maharashtra State Electricity Board refused to pay for the Dabhol power. End Comment). Finally, if the owed dues are not cleared within 90 days, the UMPP provider can sell 75

percent of the electricity that is otherwise supplied to the defaulting distribution licensee to third parties, including industrial consumers. UMPP providers can sell this power at a much higher tariff and can actually earn more money if the default persists, Johar noted. Ron Somers, the President of the U.S. Indian Business Council, said that while the open access system of selling power to third parties looks good on paper, it has never been tested. He also pointed out that the three-tier payment security mechanism was implemented five years ago as part of the electricity sector reforms implemented to attract foreign investment, but foreign investors are still reluctant to invest in this industry.

¶8. (SBU) In a separate discussion, McKinsey's Venkataraman opined that the lack of foreign interest in UMPPs could be due to a misapprehension about the project's payment security mechanism. "The perception of payment risk may deter foreign companies from bidding for UMPPs", she added. Venkataraman agreed with Johar and claimed that domestic investors are "comfortable" with the level of payment risk associated with all power projects, not only UMPPs. Sunali Rohra of McKinsey pointed out that while foreign companies are not bidding for power projects, they are still investing in the Indian power sector through infrastructure funds. So they are therefore indirectly endorsing the viability of the project, she continued.

ROE, Imported Coal and Ambiguous PPAs Are Other Obstacles for UMPP Investors

¶9. (SBU) Udai Kotak of Kotak Securities (no relation to the company's founder) and Parag Baduni from IL&FS Investment Managers believe that UMPPs offer a 14-15 percent return on equity (ROE) (the after-tax profit of a company as a proportion of its equity, expressed as a percentage). In contrast, merchant power projects (MPPs) can earn a 20-22 percent ROE by supplying power to the grid to meet peak load demand, they noted. (Note: Merchant Power Plants are not tied to any power purchase agreement. They compete for customers and absorb the full market risk. In an energy deficient state, these MPPs can sell power when demand is highest to earn high tariffs. End Note). Johar however claimed that UMPPs can earn more than 14-15 percent ROE, which he points out is the assured return for all negotiated power projects. He maintained that UMPP providers take on more risk as the project is based on the lowest tariff quoted as against other power projects where the tariff is negotiated. As UMPPs assume greater risk, the rewards necessarily have to be more than the assured ROE of 14-15 percent, he argued. (Comment: Although not explicitly stated, Johar's remarks indicated that the ROE for Tata's Mundra UMPP is estimated to be more than 14-15 percent. End Comment). Operating MPPs have other risks like problems with coal sourcing, infrequent operation as power is not supplied on a 24 hour basis, and transmission problems of connecting with the power grid, Johar continued. McKinsey's Ventkataraman argued that MPPs were "small play" and "serious" power companies would prefer to venture into "big play" UMPPs.

¶10. (SBU) Kotak also noted that UMPPs run on imported coal need to have a dedicated supply source of overseas coal. The price of imported coal factored into the price tariff quoted at the time of bidding for the project may be much lower that the price of imported coal when the project is commissioned. Bidders for UMPPs based on imported coal therefore have to tie up a reliable coal source outside India before bidding to ensure a steady and reliable coal supply, he continued. Many bidders are not equipped to buy mines or mining leases overseas, he added. Venkataraman concurred and added that if a bidder for an imported-coal fuelled-UMPP did not have access to a coalfield

and was dependent on the market price of coal, he was taking a

huge risk.

¶11. (SBU) Manjushree Ghodke, the Deputy General Manager (Economic Cell) of Larsen & Toubro, stated that the government-drafted agreements that form the basis of the public-private-partnership for infrastructure projects, including power projects, often lack clarity. These ambiguously worded agreements fail to inspire investor confidence, she said, and are responsible for the poor foreign participation in infrastructure projects. She suggested that the government appoint a legal consultant to draft these agreements to make them user-friendly, clear and transparent.

Environmental Clearance, Land Acquisition Bog Down Sasan UMPP

¶12. (SBU) Johar told us that Tata's imported-coal based UMPP at Mundra in Gujarat will be completed nearly one and a half years ahead of schedule. Work has already started and the project will be commissioned by March 2011 instead of the projected August 2012, he continued. Reliance Energy's domestic-coal based UMPP at Sasan in Madhya Pradesh has not met with similar success. The project had to be re-bid after global investor Globeleq Singapore exited and sold its stake in the project to its co-partner Lanco Infratech. Anil Ambani's Reliance Power matched Lanco Infratech's original quoted tariff and secured the Sasan UMPP. Tata Power had also bid for the Sasan UMPP but Johar stated that the winning tariff of INR 1.19 (around three cents) was "unrealistic" and admitted that "Tata would never have been able to match it." (Note: Johar believes that Reliance Power had to secure the Sasan UMPP in order to obtain a "high price" for its initial public offering. He claimed that the IPO was over-priced and noted that Reliance Power's projected energy capacity in 2012 will equal state-owned National Thermal Power Corporations current installed capacity and NTPC's shares are trading at around USD 5 as against Reliance Power's IPO price of USD 11. End Note).

¶13. (SBU) The Sasan UMPP currently faces delays of environmental and forest clearances, and problems with land acquisition and allocation. Johar told us that the project is located in the Singrauli coal belt of Madhya Pradesh where National Thermal Power Corporation already has several large power plants. Environmental clearance is subject to incremental pollution caused by a new project, he pointed out, and the base level of pollution is already high in Singrauli due to the existing power plants in the area. Johar however believes that land acquisition will be the bigger problem for the Sasan UMPP. So far no land has been acquired and media reports state that the government had even asked Reliance Power to reduce the land required for the project. The government has touted the attractiveness of UMPPs by claiming responsibility for acquiring land and securing environmental clearances, but Johar admitted that despite these assurances, procedural delays are quite common.

¶U. S. Equipment Too Expensive, Chinese Equipment Not IP Compliant or Without Adequate Capacity but Korean Equipment Just Right
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¶14. (SBU) Johar claimed that U. S. power equipment and technology is too expensive and is therefore unlikely to be used in a UMPP. Tata Power is utilizing Korean technology for its Mundra UMPP. Venkataraman's McKinsey, said that many power companies are considering using Chinese equipment for non-critical components of the power plants. The move towards made-in-China critical power equipment may take another 4-5

years, she opined. Johar, however, claimed that most Chinese power equipment suppliers were bound by technology transfer agreements so any sale to companies outside China was an intellectual property violation. To get around the technology transfer agreement, these companies sell to Chinese shell companies who in turn sell to Indian companies, he added. Johar also noted that the Indian companies who buy from the shell companies face a huge risk for if the shell companies are shut down for any reason then there will be no one to service the equipment and honor the contract. There are a few Chinese companies who have their own technology but their equipment can be used only in smaller 600 MW power plants, he continued. Tata Power is considering using this equipment for their smaller power projects but will not buy any "infringed" technology from Chinese suppliers, he maintained.

Comment:

¶15. (SBU) Public-private partnerships in ultra mega power projects were conceived to provide certainty to private investors and to reduce risk perception. However, payment security for these projects, a cornerstone of power sector investment, still hinges on private and government-owned power procuring companies of different states adhering to the power purchase agreements signed with the private developer. U. S. investors may be reluctant to place their faith on the state-owned power procurement companies given the financial crunch faced by most licensees and their poor track record (Enron, GE, Bechtel with Dabhol, and AES with Orissa). Indian energy players, however, appear quite comfortable with the payment risk associated not only with UMPPs but all power projects. The disparity between the two viewpoints indicates a possible lack of understanding or misperception about the current scenario in the Indian power sector and energy reforms implemented since Dabhol. But as Tata Power Johar's said, you have to be prepared to face Indian terms and conditions if you want to invest in India. End Comment.
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